

**COMMENTS ON THE CREDIT UNION TAX EXEMPTION
TO THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM**

Credit Union National Association

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Washington, DC

The Credit Union National Association (CUNA) is pleased to provide comments to the President's Advisory Panel on Federal Tax Reform, and commends Chairman Connie Mack III and Vice-Chairman John Breau for their leadership on this project. CUNA is the largest credit union trade association, representing approximately 90% of our nation's nearly 9,300 state and federal credit unions and their 86 million members.

CUNA strongly believes that the credit union exemption from federal income tax is sound public policy and urges the Advisory Panel to reaffirm this conclusion. Our recommendation is based on the following:

- The original justification for the tax exemption still holds.
- Credit unions serve those of modest means at reasonable costs.
- Over 86 million credit union members receive substantial benefits.
- The tax exemption ensures the cooperative alternative is available.
- There is no evidence of market disruption from the tax exemption.

Original justification for the credit union tax exemption still holds.

Since inception, credit unions' tax exemption has had absolutely nothing to do with either field of membership restrictions or the extent to which credit union service offerings were limited. Rather, the original reasons for the tax exemption have had everything to do with the cooperative structure of credit unions. The U.S. Treasury Department underlined this fact in its most recent comprehensive report on credit unions outlining the rationale for the tax exemption for federal credit unions:

Two reasons were given for granting this exemption (in 1937): (1) that taxing credit unions on their shares, much as banks are taxed on their capital shares, "places a disproportionate and excessive burden on the credit unions" because credit union shares function as deposits; and (2) that "credit unions are mutual or cooperative organizations operated entirely by and for their members . . ." Thus, the tax exemption was based primarily on the organizational form of credit unions. . . (Quotes within this excerpt are from H.R. REP. NO. 1579, 75th Cong., 1st Sess. P. 2.)¹

¹ U.S. Department of the Treasury "*Comparing Credit Unions and Other Depository Institutions*", January 2001. Page 28.

Similarly, the rationale for the tax exemption for state credit unions hinges on their cooperative structure. In a 1991 report, the GAO found:

Under current law, state credit unions are exempt from tax under Internal Revenue Code section 501(c)(14)(A). This section states that credit unions that are (1) operating on a nonprofit basis, (2) organized without capital stock, and (3) operating for mutual purposes can qualify for exemption.²

Today, credit unions continue to operate as democratically controlled mutual institutions, serving their members on a non-profit basis. Rather than distributing net income among stockholders (as do banks), the bulk of it is returned to members in lower loan rates and fees, or higher yields on savings. The balance is retained by the credit union to comply with statutorily mandated net worth requirements that protect the federal share insurance fund and the taxpayer from loss.

Congress recently reaffirmed the tax treatment of credit unions in the findings to the Credit Union Membership Access Act of 1998:

The Congress finds the following: . . .

(4) Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.³

The significance of the credit union tax exemption is well understood by public officials. Last year, both President Bush and Senator Kerry wrote letters affirming their appreciation for the important service that credit unions provide to their 85 million

² GAO, July 1991. Page 292.

³ Pub. L. No. 105-219. August 7, 1998.

members, and indicating their support for the continuation of credit unions' tax exemption.

Credit unions serve those of modest means at reasonable costs.

A recently published study found that: "Households that use a bank only have higher median incomes than those who use a credit union only." and "Among households that use both a bank and a credit union, those that use a bank primarily have higher median incomes than those that use a credit union primarily."⁴

A significant way credit unions provide value to America's working class and modest income consumers is through the pricing of their services. Numerous studies and reports show that credit unions charge fewer and lower fees than do banks for the same kinds of services.⁵ In particular, minimum balances to avoid fees are typically much lower at credit unions than at banks. Lower rates on loans, especially on used cars and small loans are another way credit unions serve those of modest means. Credit unions also serve America's low and moderate-income households with member business loans. The Treasury reported in 1999 that 45% of credit union member business loans were to borrowers with household incomes below \$50,000.⁶ In addition, Home Mortgage Disclosure Act (HMDA) data consistently shows that low income or minority applicants are significantly more likely to have their loans approved at a credit union than at any other type of lender.

Throughout most of their history, credit unions have actually been hamstrung in their efforts to serve members of modest means because field of membership rules generally restricted eligibility to occupational groups. Four years ago, the National Credit Union Administration adopted an expedited program known as Access Across America to permit federal credit unions to add underserved areas to their fields of membership. Since the beginning of 2001, over 92 million potential members from underserved areas have been added to credit union fields of membership. Credit unions acknowledge it will

⁴ Jinkook Lee and William Kelly, *Who Uses Credit Unions*, Third ed. Filene Research Institute, 2004. Page 15.

⁵ *2004-2005 Credit Union Fees Survey*, Credit Union National Association. *Big Banks, Bigger Fees 2001*, US Public Interest Research Group. New Jersey Department of Banking and Insurance, various surveys. The Money Talks Personal Finance Advice website at www.moneytalks.org.

take some time to reach out to and serve members in these communities. However, in the three years ending December 2003, credit unions that added such underserved areas experienced membership growth over three times that of other credit unions (17.4% vs. 5.2% over the three year period.)

86 million CU members receive substantial benefits.

Credit unions provide substantial, tangible benefits to members that far exceed the amount of the tax exemption. These benefits are realized in the form of lower fees, lower loan rates, and higher yields on savings. CUNA has estimated that these benefits total over \$6 billion a year.⁷ That is the additional amount that credit union members would pay if they were to conduct all the business they do with credit unions at banks instead. That is about four times the roughly \$1.5 billion that credit unions would pay in federal income tax.

The tax exemption is leveraged as it is for the benefit of credit union members because of the cooperative structure of credit unions. When comparing banks to credit unions, the amount that banks pay in dividends to stockholders is more significant than is the tax exemption. Further, credit unions pay very little compensation to directors, with the savings passed on to members. Finally, credit unions ratios for expenses and loan losses compare very favorably to similarly sized banks.

Tax exemption keeps the cooperative alternative available, and supports safety and soundness.

Credit union regulation, which is much more restrictive than that for other financial institutions, includes: limits on who the credit union can serve, limits on business lending, lack of access to capital markets, etc. The tax exemption is the incentive that encourages credit union CEOs and boards to continue to operate as credit unions rather than throwing off the restrictions by converting to a bank charter. Such conversions would only limit the range of choices available to America's consumers, especially those of modest means.

⁶ US Department of the Treasury. *Credit Union Member Business Lending*. January 2001.

⁷ *The Benefits of Credit Union Membership*. CUNA Research and Policy Analysis White Paper, 2004.

Because the tax exemption is an important part of the reason credit unions remain cooperatives, it serves to protect taxpayers from losses to the share insurance fund. There are two important connections between the stability of NCUSIF and credit unions' tax exemption. First, the primary buffer for a deposit insurance system is the capital or net worth maintained in insured institutions. Because credit unions have no access to capital markets, their only source of capital is the retention of earnings. A tax on net income would thus disincent credit unions from retaining earnings, weakening protection for NCUSIF. In fact, the cost to the taxpayer of FSLIC's losses far exceeded the total taxes paid by FSLIC insured institutions prior to FSLIC's failure.

Second, as cooperatives credit unions have a systemic inclination to avoid risky activities. Kane and Hendershott have shown that the cooperative structure of credit unions presents credit union decision makers with incentives that are strikingly different from those faced by a for-profit financial institution, making it less feasible for credit union managers to benefit from high-risk strategies.⁸ This is an especially useful trait for federally insured depository institutions.

Large credit unions stand out in providing credit union benefits.

There is no relation between the size of an institution and the absence or presence of reasons to justify the tax exemption. Large credit unions are democratically controlled, not-for-profit cooperatives in every way that smaller credit unions are. The boards of directors of large credit unions are composed of volunteers just as they are at small credit unions. A large credit union may be more likely to offer a broader array of services, and to be a greater presence in a local market. But neither activity makes it less a cooperative than a smaller credit union. No one suggests that as soon as the congregation of a church, synagogue or mosque exceeds a certain size, it should no longer be tax exempt. Likewise, it would be ludicrous to say the American Heart Association should lose its tax exemption simply because of its size while a small local charity should not.

⁸ Edward Kane and Robert Hendershott, *The Federal Deposit Insurance Fund that Didn't Put a Bite on U.S. Taxpayers* Journal of Banking and Finance, 20(September, 1996), pp.1305-1327.

Because of their size and efficiency, large credit unions are often more able to provide the benefits of the cooperative to members, such as lower loan rates and fees and higher dividend rates. Larger credit unions are also more able to offer special programs benefiting low- and moderate-income households. In a survey conducted in 2002, when asked how many of up to 18 services geared to low/mod income households were offered, only 6% of credit unions with assets below \$20 million offered at least half of the services. Fully 42% of credit unions with assets over \$500 million offered that many of the services. Large credit unions are also more likely than small credit unions to participate in outreach activities to attract low/mod income members, and to have added underserved areas to their fields of membership under NCUA's Access Across America program.⁹

No evidence of market disruptions from credit union tax exemption.

Other financial institutions continue to thrive in the presence of credit unions. The FDIC recently reported that banks recorded record profits for the fourth year in a row.¹⁰ Aggregate bank return on assets (ROA) has exceeded 1% for the past 12 years, averaging 1.23%. And credit unions are only growing marginally faster than banks. In the decade ending in 2004, total banking institution assets grew at a compound annual rate of 7.25% compared to 8.4% for credit unions. Credit unions now account for 6.2% of the combined assets of all depository institutions. At the growth rates of the past decade, it will take until the year 2053 for the credit union share to climb to just 10%.

The health of the banking industry over the past decade has not been confined to just large banks. In a 2003 conference, Federal Reserve Gov. Mark Olson said: "The year that just ended was one of record profits for the industry as a whole, and for community banks in particular." and "Community banking has a long history of strength and success and a bright future. The past year was a good one for community banks. Once again the vitality and adaptability of the community banking franchise were amply demonstrated."¹¹ Two Federal Reserve economists have recently described the strong performance of the nation's smaller banks. They found that "small banks have grown considerably more

⁹ 2003 *Serving Members of Modest Means Survey Report*. CUNA.

¹⁰ Federal Deposit Insurance Corporation, *Quarterly Banking Profile, Fourth Quarter 2004*.

¹¹ Comments before the 2003 Chicago Federal Reserve Bank Conference: Whither the Community Bank?

rapidly than large banks and have tended to meet or exceed them in some measures of profitability.”¹²

Summary.

America’s credit unions continue in their long tradition of providing members affordable financial services driven by their cooperative, not-for-profit structure. As a result, 86 million members receive significant benefits from their credit unions even while the rest of the financial services industry thrives. The public policy rationale for the credit union tax exemption is just as valid today as it was at credit unions’ inception.

¹² William F. Bassett and Thomas F. Brady. *The Economic Performance of Small Banks, 1985-2000*. Federal Reserve Bulletin, November 2001.